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Nos. 521-522

In the Supreme Court of the United States

OCTOBER TERM, 1930

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

EDITH ANDREWS LOGAN

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JULIA ANDREWS BRUCE

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

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PETITION

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the

Second Circuit entered in the above-entitled cases on May 26, 1930, reversing the decision of the United States Board of Tax Appeals.

STATEMENT

These cases involve deficiencies in income taxes determined against the respondents for the calendar years 1918, 1919, 1920. (R. 69.)[1] The facts in the cases are practically identical.

Prior to March 1, 1913, and until March 11, 1916, the respondents owned certain shares of the stock of the Andrews & Hitchcock Iron Company, which company held a 12% stock interest in the Mahoning Ore & Steel Company. The latter company controlled, by a lease for a long term of years, an iron-ore mine. The Mahoning Company was an operating company, and, pursuant to contract provisions, distributed the ore which it mined only to its stockholders, who were steel manufacturers. (R. 30–31, 103–107.)

On March 11, 1916, the Youngstown Sheet & Tube Company purchased all the outstanding capital stock of the Andrews & Hitchcock Company, thus acquiring the 12% stock interest in the Mahoning Company and the right to a percentage of the ore mined by it. The Youngstown Company paid $2,200,000 in cash for the Andrews & Hitchcock stock, and in addition contracted to pay the former stockholders of the latter company sixty cents per

[1] All references herein are to the record in the case of Edith Andrews Logan unless otherwise indicated.

ton for each and every ton of iron ore which the Youngstown Company might thereafter become entitled to receive from the Mahoning Company. Payments were to be made annually under the contract and the stock in the Mahoning Company was to be deposited as collateral security. (R. 97–103.) Respondents thus acquired rights to payments under this contract in proportion to their holdings in the stock of the Andrews & Hitchcock Company. Mrs. Logan acquired a 250/4,000 interest and Mrs. Bruce acquired a 350/4,000 interest. (R. 99.)

In 1917 the mother of the two respondents died, and each acquired by bequest an additional 550/4,000 interest in the contract. (R. 37, 92.)

The fair market value of the Youngstown contract, at the date of its receipt, was found by the Commissioner to be $1,942,111.46. For lack of evidence to the contrary this value was approved by the Board. (R. 57.) The value of the 550/4,000 interest which each acquired by bequest was fixed at $277,164.50 for purposes of Federal estate tax at the time of the mother's death. (R. 37.)

During the years here involved the Youngstown Company made payments in accordance with the terms of the contract, and respondents respectively received sums proportionate to the interests which they acquired by exchange of property and by bequest. (R. 35–37.)

The Board held that respondents' receipts from the contract, during the years in question, represented " gross income "; that respondents should

be allowed to deduct from said gross income a reasonable allowance for exhaustion of their contract interests; and that the balance of the receipts should be regarded as taxable income. (R. 57, 58–59.)

The Circuit Court of Appeals reversed the Board's decision. It held that no part of the receipts constituted taxable income; and that no income would be received until respondents had first recovered:

> (1) As regards their interests in the contract acquired by exchange of property, the March 1, 1913, value of the property exchanged, and
>
> (2) As regards their inherited interests the value of those interests at the time of their mother's death.

Four other stockholders of the Andrews & Hitchcock Iron Company appealed from the same decision of the Board of Tax Appeals which the Court reviewed in this case. Their cases were taken to the Circuit Court of Appeals for the Sixth Circuit on a consolidated record entitled *Frank Hitchcock* v. *Commissioner of Internal Revenue*, No. 5550. That case was argued orally on April 17, 1930, but no decision has been rendered. By reason of that fact application was made for an extension of the period within which petition for certiorari could be filed. An order extending the time for a period

of sixty days from the date of the order was signed by Mr. Justice Van Devanter on August 22, 1930.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the contract right to receive annual payments in the future had no fair market value, and that the sale of stock by which the contract was acquired was therefore not a closed transaction.

2. In holding that the contract did not have a fair market value of $1,942,111.46 on March 11, 1916, as determined by the Commissioner and approved by the Board of Tax Appeals.

3. In holding that the difference between the $2,200,000 in cash and the March 1, 1913, value of the stock must be returned through the payments under the contract before there could be any income from the contract right acquired through the sale of stock.

4. In failing to recognize that the interest acquired in the contract through inheritance presented a question not controlled by the determination that the interest acquired through sale of stock had no fair market value, and in applying the same reasoning to both interests. There is no finding that the inherited interest was not capable of being capitalized anew. On the contrary, the opinion below recognizes that it had a capital value.

5. In holding that the payments received by respondents under their contract rights were not taxable in any part as income during the years 1918, 1919, and 1920.

REASONS FOR GRANTING THE WRITS

In so far as the respondents' interests were inherited, the decision of the Circuit Court of Appeals is in conflict with that of the Circuit Court of Appeals for the Sixth Circuit in *Eldredge* v. *United States,* 31 F. (2d) 924, where it was held that payments made to one of the owners of a contract which produced a return on each ton of coal mined by a corporation from a certain mine represented part income and part return of capital.

With respect to the interests in the contract acquired both by purchase and by inheritance, the identical questions here involved are now pending before the Circuit Court of Appeals for the Sixth Circuit in cases brought by other stockholders of the Andrews & Hitchcock Iron Company to review the same decision of the Board of Tax Appeals which is involved in the instant cases. If that court follows its earlier decision in the *Eldredge case, supra,* a direct conflict between the Circuit Court of Appeals for the Second Circuit and the Circuit Court of Appeals for the Sixth Circuit will be presented on both questions.

The question of when income is derived from annual payments under a contract such as here in-

volved is one of present importance in the administration of the Revenue Acts. Under the decisions rendered herein the first annual payments from the contract would be regarded as a return of capital and no taxable income would be derived for many years. After the capital has all been recovered it would seem that the payments in the future years would all be income. Thus under the decisions below no tax may be imposed upon the payments in the earlier years, but the burden of the tax will be heavy in the later years when the payments will be treated as all income. Accordingly, the principles of tax law involved in these cases are of general public importance, from the standpoint of both the Government and the taxpayers.

These principles would doubtless be applicable to the owners of all royalty contracts. Moreover, as pointed out by the Board of Tax Appeals in *Florence L. Klein* v. *Commissioner*, 6 B. T. A. 617, 622, the theory of apportionment which has been disapproved below is applicable to partial sales of single plots of real estate and to those who retail goods purchased in bulk.

Wherefore, it is respectfully submitted that this petition for writs of certiorari to review the judgments of the Circuit Court of Appeals for the Second Circuit should be granted.

THOMAS D. THACHER,
Solicitor General.

OCTOBER, 1930.

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BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the Circuit Court of Appeals in the *Logan case* is reported in 42 F. (2d) 193, and the opinion in the *Bruce case* is reported in 42 F. (2d) 197. The findings of fact and the opinion of the Board of Tax Appeals (R. 27–68) are reported in 12 B. T. A. 586.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered May 26, 1930. On August 22, 1930, the time for filing this petition was extended to October 21, 1930. Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Respondents acquired certain interests in a contract by virtue of which they received annually certain payments measured by the number of tons of iron ore delivered from a certain mine. The question presented is whether the payments received under the contract are to be regarded in the earlier years as entirely a tax-free recovery of capital, as held by the Circuit Court of Appeals, or whether each payment is to be regarded as partly a return of capital and partly the receipt of income.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1062, 1064, 1065, 1066:

SEC. 210. * * * There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax * * *.

SEC. 211. (a) * * * in addition to the normal tax imposed by section 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual, a surtax * * *.

SEC. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

* * * * *

SEC. 213. That for the purposes of this title * * * the term "gross income"—

(a) Includes gains, profits, and income derived from * * * dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *.

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

* * * * *

Regulations 45 (1920 edition) relative to the Revenue Act of 1918, provided:

Art. 201. Depletion of mines, oil and gas wells; depreciation of improvements.

* * * * *

When used in these articles of the regulations covering depletion and depreciation—

* * * * *

(*b*) The "fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase. Where there has been no sale and the fair market value at the basic date is to be used, such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date.

STATEMENT

The facts are stated in the petition for certiorari.

ARGUMENT

The interests acquired by each respondent by inheritance from their mother was valued for inheritance tax purposes at $277,164.50. (R. 37, 92.)

The considerations which led the Circuit Court of Appeals to hold that the interests acquired by the sale of the respondents' stock could not be recapitalized by the Commissioner had no application to the inherited interests. In so far as the inherited interests are concerned the question is squarely presented whether the annual payments include income in any part. In holding that these payments consisted wholly of capital returns the court below has taken a position directly in conflict with that of the Circuit Court of Appeals for the Sixth Circuit in *Eldredge* v. *Commissioner*, 31 F. (2d) 924. In that case the taxpayer owned a contract which produced a payment of two and one-half cents on each ton of coal mined by a corporation from a certain coal mine, and the court was called upon to decide what portion of said payments represented taxable income. The decision states in part as follows (p. 928):

> It does not, however, follow, as appellants contend, that nothing is taxable until appellants have received payments to an aggregate amount exceeding the 1913 capital value. The statement that a taxpayer is entitled to return of capital means nothing more than that, by the time he has received all the money coming to him in a transaction, he must have been allowed to deduct his full capital; it does not necessarily mean that no tax is to be imposed until the entire capital shall have been received.

The same principle was recognized in *Rosenberger* v. *McCaughn* (C. C. A. 3rd), 25 F. (2d) 699, certiorari denied, 278 U. S. 604. In that case an owner of land demised to a coal company all coal under the land with the right to mine it for a term of 99 years in consideration of monthly rents reckoned on the coal raised and the price realized. The court there said (p. 701):

> Reverting to the plaintiff's contention that all payments she had received under the instrument here in question were tax free because they were part payments of the purchase price of property sold prior to March 1, 1913, still—always keeping in view the nature of mining, the source of the proceeds—we think each payment represented in some measure both capital and increment, capital because it stood in the place of coal and increment because in the payments running through ninety-nine years' interest on the capital must inevitably have been included, and that this increment or interest was a gain "derived" within the generalization of the statute "from any source whatever" and was income in substantially the sense of *New Creek Co.* v. *Lederer* (C. C. A.) 295 F. 433.

The reasonableness of this plan is evident, for it places the respondents' income from the mine on the same general plan as is used in computing the income of the ore-producing company itself. As the Mahoning Mine is developed the Mahoning Ore

& Steel Company reports its gross income and receives a deduction for depletion proportionate to the decrease in value of its leasehold interest. While in the instant cases the Commissioner divided the royalties received as between a return of capital and income, the result reached is the same as if the entire royalties received had been included in gross income and an allowance for exhaustion of the contract treated as a deduction from this gross income. Thus the analogy between "depletion" and "exhaustion" pointed out by this Court in *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, is observed and the principle of gradual capital recovery, explained by this Court in *United States* v. *Ludey*, 274 U. S. 295, is recognized.

Under the plan approved by the Circuit Court of Appeals no such equitable result would be obtained. The first annual payments from the contract would be regarded as all capital and the Government's right to taxation of income would be long deferred.

That even where the payments clearly represent deferred installments of the purchase price there is an element of income present, if the period of payment is extended over a term of years, has been recognized by the courts in several decisions. See *Ruth Iron Co.* v. *Commissioner of Internal Revenue* (C. C. A. 8th), 26 F. (2d) 30; *Kosmerl* v. *Commissioner of Internal Revenue* (C. C. A. 7th), 25 F. (2d) 87; *Rosenberger* v. *McCaughn, supra; Platt* v. *Bowers*

(S. D. N. Y.), 13 F. (2d) 951. The reason therefor is apparent when it is considered that an obligation for a sum total of deferred payments over an extended period must be discounted as to present worth and as payments are made they indisputably contain other elements than capital return.

The plan of capital recovery approved by the court in this case might result in no taxable income ever being derived from the Youngstown contract. The plant necessarily postpones the receipt of "income" until all "capital" has been recovered. If respondents should die prior to the time when the capital has been entirely recovered their right to future income would be recapitalized for their heirs, just as was done upon the death of the respondents' mother, and the receipt of income would be still further postponed. Thus it is possible that respondents' interests in the Youngstown contract might pass by inheritance from one person to another, and that no tax on the annual payments would ever become payable.

With respect to the interests which were acquired by the sale of stock the Board of Tax Appeals held that the stockholders of the Andrews & Hitchcock Company had in 1916 exchanged their capital stock for an income-producing contract having a "fair market value"; that the exchange was, for tax purposes, a closed transaction; and that all future receipts from the contract, less a reasonable allowance for exhaustion of the contract, were taxable in-

come. The court below held that the contract had no "fair market value" in 1916; hence, that there was no closed transaction; and that respondents were entitled to recover the March 1, 1913, value of the stock which they had exchanged.

In *Chicago Ry. Equipment Co.* v. *Blair* (C. C. A. 7th), 20 F. (2d) 10, the court recognized fair market value to be the price which one under no compulsion is willing to take for property which he has for sale, and which another, under no compulsion, being desirous and able to buy, is willing to pay for the article. The court said (p. 14):

> It is not necessary that a property shall be for sale before it can have a market value. Neither is it necessary that there shall be a known buyer for it.

Respondents' witnesses did not state that the contract could not be sold or that it had no realizable value. Their testimony was merely that they knew of no sales by which the fair market value could be determined, no "general market" for contracts of that character, and no "established or current market price" (R. 131, 132). Witness J. B. Putnam, when asked why he believed that the "real value" could not be realized in cash, testified that the elements which determined value were not definitely fixed. (R. 132.) It is evident that the meaning of the witness was not that the contract was not salable, but rather that its value was subject to uncertainties. Such evidence might tend

to show a low market value but it is not sufficient to overcome the Board's finding that there was a "fair market value."

The stockholders of the Andrews & Hitchcock Company were assured payments of 60¢ per ton on 12% of the total ore reserves of the Mahoning Ore Company and the payments were guaranteed by collateral security. The Mahoning Mine, on the production of which the payments were to be measured, was one of the leading and largest iron ore properties in the country. (R. 172.) The ore content of the mine could be accurately estimated. (R. 173.) The rate of production could be calculated with reasonable certainty from twenty-six years of actual production history. (R. 159, 96.) It can not be doubted that this contract, which was yielding its owners large sums annually, had intrinsic value as well as a market value. The "fair" market value was largely a matter of calculation.

The fair market value of the contract actually was determined in 1917 when respondents' mother died, and that value was used for Federal estate tax purposes. No reason appears why the fair market value was not determinable also in 1916.

The Commissioner of Internal Revenue found that the contract had a fair market value in 1916 of $1,942,111.46 and his determination was approved by the Board of Tax Appeals. (R. 57.) The respondents offered no evidence to show error

on the part of the petitioner in making such determination. The petitioner's determination was prima facie correct and in the absence of contrary evidence it should have been accepted. *Bishoff* v. *Commissioner of Internal Revenue* (C. C. A. 3d), 27 F. (2d) 91, 93.

CONCLUSION

In view of the need of a definite rule for the guidance of the courts and the Treasury Department, it is respectfully submitted that the petition for writs of certiorari should be granted.

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OCTOBER, 1930.

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